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February 17, 1995

EX PARTE PRESENTATION

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

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FEB 17 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY


Re: CC Docket No. 92-77 - Billed Party Preference

Dear Mr. Caton:

In Sprint's August 1, 1994 Comments (at 19-20) and September 14, 1994 Reply Comments (at 26-28), it argued that the cost-benefit analysis in the Commission's Further Notice of Proposed Rulemaking had significantly underestimated the commissions expense incurred by interexchange carriers in the current environment. Further evidence that this is the case can be found in Alix M. Freedman, "'Mom, It's Mugsy,' Phone Firms Wrestle For Prisoners' Business In Hot Growth Market," Wall Street Journal, A1, A11 (February 15, 1995), which reports that in a recent contract with the Kentucky prison system, MCI agreed to pay commissions amounting to 55% of its gross revenues. The article may be relevant to other aspects of the cost-benefit analysis as well. For example, it estimates that the prison market, from which there presumably is no significant amount of dial-around calling, now approximates \$1 billion.

For the Commission's convenience, a copy of the article is enclosed. An original and one copy of this letter are being filed.

Respectfully submitted,


H. Richard Juhnke
General Attorney

Attachment

c: Karen Brinkman
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List A B C D E

'Mom, It's Mugsy'

Phone Firms Wrestle For Prisoners' Business In Hot Growth Market

Big Companies Dangle Cash, Add Antifraud Devices To Entice Jail Officials

Callers Who Hate to Wait

By ALIX M. FREEDMAN

Staff Reporter of THE WALL STREET JOURNAL

NEW YORK — In an airless cubicle, inmate Hugo Rivera intently cradles the telephone he describes as "the sunshine in this place." After 15 minutes, his call is automatically disconnected. Reluctantly ceding his spot to another prisoner, Mr. Rivera plants himself outside the phone room to wait for another turn.

"We're phone Joneses"—addicts—the burly 22-year-old explains. "This is our little bit of freedom, our step back into the street." Mr. Rivera, who has racked up \$60 phone bills each week since coming to the tough Rikers Island jail on a drug charge two months ago, adds a business note: "For phone companies, prisons are a sure score."

As Mr. Rivera has figured out, few have reaped richer rewards from the nation's tough stance on crime than telephone companies. Calls from most prisons must be made collect, one of the most expensive services. On top of that, the companies impose hefty surcharges on the recipients of prisoners' calls. Further, inmates' conversations tend to last longer than those of people on the outside. The upshot: A single prison phone can gross as much as \$15,000 a year — fully five times more than a pay phone on a street corner.

All this helps explain why AT&T Corp. and MCI Communications Corp. crave the inmates' business. Although the two biggest carriers aren't eager to publicize their efforts, they have been waging a fierce battle against the Baby Bells and a host of no-name carriers for control of some 50,000 pay phones in the roughly \$1 billion behind-bars business.

'Trash Traffic' No More

"The major players are showing up in force, with all the financial strength they can muster," marvels Sandy Vaello, president of Northern American IntelCom Inc., a phone company owned by Dallas oil concern Diamond Shamrock Corp. "A couple of years ago, you couldn't entice the major carriers into looking at this traffic. It was trash traffic — and they didn't want it."

Nowadays, with competition intense for residential and commercial customers, AT&T and MCI can't afford to be so standoffish. The nation's more than one million inmate callers are already big customers, and their ranks are expected to double by the year 2005 if current trends continue. In fiscal 1995 alone, more than 150 new state and federal prisons are projected to be built, and 117 facilities expanded. In addition, correctional facilities offer a guaranteed lock on the traffic; unlike free citizens, inmates don't get to pick their favorite long-distance carrier. And a new breed of fraud-proof pay phones has reduced the risks of relying on customers who may have larceny in their hearts.

'Golden Egg'

"Prisons have the highest margins around," says John Gamino of John Richard Associates, an industry consulting firm. "It's a golden egg."

John Jacquay, an MCI senior vice president, estimates that his company's aggressive push into the prison market has increased its share of inmates' long-distance calls to about 30% from 10% three years ago. As he delicately puts it: "We want to go after those situations where we know there is a high propensity for people to want to communicate outside of where they're staying." Dana Motyl, an AT&T inmate-calls manager, acknowledges that captive customers represent "one of the only growth spots out there in the declining collect-call market," though she won't divulge specifics on AT&T's market share or profits.

If the phone companies seem a bit shy about admitting their infatuation with criminals, the prison community isn't nearly so reticent about the objects of its affection. Wardens revere telephones as a management tool — one of the few luxuries they can withhold as punishment. Prisoners extol them as a preserver of family ties. Phones also incite inmates to jealous rages. Two years ago, a Rikers inmate killed another who failed to get off the phone quickly enough.

Holding the Line

A new Rutgers University study at Rikers shows that officials managed to cut phone-related violence in half by automatically disconnecting calls to reduce waits. In his latest single, "Behind Bars," incarcerated rapper Slick Rick alludes to a fight triggered by an inmate who hogged the phone "like he didn't know how to hang up." During a recent MTV interview, the star opined that "phones are like diamonds in jail."

Phone firms have learned that, as with most other aspects of prison life, inmates' keepers hold the keys. So valuable is the business that companies now routinely pay prison systems millions of dollars in annual fees, which they call commissions, for the exclusive right to operate the phones. Firms also offer signing bonuses and up-front advances. The money has become a mainstay for strapped state and county corrections bureaucrats. For instance, last

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'Mom, It's Mugsy': Phone Firms Wrestle for Prisoners' Business

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year Massachusetts received about \$3 million in commissions from inmate phone calls. In addition, prisons often get free use of phone technicians and pricey equipment to tape inmates' conversations.

In return comes the exclusive right to a given facility's local or long-distance traffic; depending on regulatory constraints, sometimes the same carrier gets both.

Statewide Contracts

With AT&T and MCI salesmen beating down doors, the fight for statewide prison systems, which boast the most inmates and the most long-distance traffic, is particularly fierce. In December, MCI captured Kentucky's 7,500 inmates by agreeing to return to the state 55% of its gross on an estimated \$5 million of long-distance and local-phone revenues. This was about double Kentucky's previous take. Ken Dressman, principal assistant to the corrections commissioner, says the munificence left him "flabbergasted."

MCI and AT&T are romancing the local sheriff, too. Late last year, AT&T wrested the three-year long-distance contract for the Los Angeles County jail system, the nation's largest, from LDDS Communications Inc., a Jackson, Miss., firm. Now with a guaranteed \$6 million in commissions under his belt, Terry Carlton, the corrections official who pulled off the deal,

is already anticipating the next bidding war. While San Francisco-based Pacific Bell has his jail system's local traffic locked up for the next few years, Mr. Carlton says MCI and AT&T have made no secret of their expansionist intentions. Nor is this official averse to divulging his: "Three years from now, I hope to sit in a big chair and watch them all throw money at me," he says.

The bidding war over commissions has put a temporary damper on profit margins, though not on the phone companies' ardor. MCI's Mr. Jacquay says "very hungry" competitors have eroded profit margins in the niche to "less than 5% compared to 10% to 12% four or five years ago." Another special challenge in this market is controlling bad debt, whether from fraud or unpaid bills.

Still, the business is worth pursuing, notes an AT&T spokesman, "because it contributes to the company's overall market share." And it is widely believed in the industry that once the giants push smaller companies out of the niche, commissions will come back to earth. Even now, AT&T is finding ways to cushion its costs. The company recently imposed a special fee of \$3 on interstate collect calls made from the prisons where its antifraud equipment is in use. Now AT&T is seeking regulatory approval to apply the surcharge to in-state long-distance calls as well.

AT&T says it is only trying to recoup the costs of supplying special equipment. But James Burton, president of Telequip Labs Inc., a Richardson, Texas, provider of antifraud devices, says that "the industry knows this is 100% about AT&T defraying the costs of its commissions, but everyone is ecstatic because they can ride the windfall, too."

All this wheeling and dealing was unheard of just a decade ago. Before deregulation, the prisons that provided telephones at all tended to be customers of the local phone company and were usually treated like stepchildren. The big problem from the phone companies' perspective? "Live operators weren't trained to handle corrections traffic so they were highly susceptible to the conning ability of inmates," says Marty Goldman, a market manager at Executone Information Systems Inc., of Milford, Conn.

Instant Highfliers

By the late 1980s, small, independent pay-phone carriers revolutionized the turf. Their innovation: substituting the live operators, who handled collect calls, with automated voices. The ensuing reduction in fraud and labor costs made the business so lucrative that independents began relying heavily on commissions to nail down the business. This strategy — often financed by huge increases in the prices paid for prison calls — turned a number of tiny carriers into instant highfliers.

But competition and closer scrutiny by state officials are eliminating most opportunities for price-gouging. The Louisiana Public Service Commission, for instance, ordered Global Tel-Link, a Mobile, Ala.,

unit of Schlumberger Technologies Inc., to refund \$1.2 million in alleged overcharges from June 1993 to May 1994. Independents are also finding it difficult to hold their own in an escalating technology war.

Indeed, phone companies are increasingly combining their promises of big commissions with claims of ever-more-sophisticated measures to combat fraud. It's no wonder: Prisons are schools for scam artists. Frederick's of Hollywood, the famed purveyor of frilly lingerie, estimates that 25% of its credit-card fraud emanates from prison. The retailer keeps a list of prison zip codes and subjects prison-bound orders to additional scrutiny.

George Wagner, warden at a county jail in Flemington, N.J., describes the conventional phone system there as a breeding ground for larceny. By posing as a police officer doing a credit-card investigation, one jail inmate recently got people to divulge their credit-card numbers over the phone and then dialed out again for more than \$2,500 of goods.

To deter such shenanigans, even the most bare-bones prison-phone contracts generally provide for systems that announce on the line the identity of both inmate and prison before a collect-call conversation can get under way. Beyond that, the more advanced systems enable corrections officials to block selected numbers, thus preventing inmates from dialing out at random. Toll-free numbers are also off limits. Increasingly, too, state prisoners are confined to a small list of preapproved phone numbers. Phone marketers even have begun to hawk a "voice-verification" feature. This takes a digital print of an inmate's voice to ensure that prisoners

aren't calling fellow inmates' approved numbers.

Phone firms are now racing to find a solution to an additional problem: inmates' penchant for dialing friends and family members who, in turn, forward the calls to accomplices, witnesses or mail-order houses.

To deal with this concern, AT&T has been particularly aggressive in touting its device, which it dubs "Strike Three," designed to detect and disconnect such third-party calls. The phone giant claims that Strike Three, which works by listening for clicks and silences on a phone line, is 93% effective in tests conducted by Bell Laboratories, AT&T's in-house testing facility. "No one else comes close," its ads in prison-industry magazines proclaim, though some competitors sharply disagree.

Eavesdropping equipment is another feature that is popular with wardens. Though the phone companies generally don't manufacture such devices, they often provide them to prisons at no charge. In

the recording and monitoring room at the Massachusetts Correctional Institution in Norfolk, Mass., an alarm goes off intermittently. Stephen Gatewood, a security officer, explains that this alerts officers whenever an inmate under active suspicion dials out. At a visitor's request, Mr. Gatewood monitors one such call, placed by an inmate suspected of drug activity. Not only does Mr. Gatewood get to listen to the conversation as it unfolds but his computer gives him access to all sorts of other crucial data. He can see the number the inmate is calling, which prison phone he is calling from and even how often this number gets called by other inmates.

"Phones have definitely become an investigative tool, like informants and other types of surveillance techniques," Mr. Gatewood says. Just the day before, he adds, the prison recorded an inmate who had been denying suspected drug use behind bars. In the ersatz privacy of the phone room, he confided his heroin use—to his mother.